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SUBJECT: UKRAINE: SCENESETTER FOR AMBASSADOR MORNINGSTAR'S
VISIT TO KYIV

¶1. (SBU) Summary. Your June 19-20 visit to Ukraine comes in the midst of a severe economic crisis and an increasingly tense political environment ahead of presidential elections in 2010. The gas supply and transit contracts signed by Naftohaz and Gazprom in January 2009 increased transparency somewhat and ended the gas crisis that saw gas shutoffs to EU member states. Naftohaz's precarious financial situation, however, has called into question its ability to comply with the contracts, which introduced stringent payment requirements. Ukraine's strategically vital gas pipelines transit 80 percent of the natural gas Europe purchases from Russia but need at least $3 billion in technical upgrades to ensure the system's reliability and increase efficiency. Ukraine has been slow to adopt reforms that the EU and international financial institutions have said are necessary before they provide financing for the pipeline modernization. Ukraine also remains heavily dependent on Russia for oil, for 100 percent of its nuclear fuel and for 60 percent for storage of its spent nuclear fuel. Ukraine's economy is one of the most energy intensive in the world, but Ukraine has done little to attract foreign investment in its energy sector or to encourage increased energy efficiency. End summary.

Ukraine-Russia Gas Relationship

¶2. (SBU) The January 2009 gas supply and transit contracts signed by Naftohaz and Gazprom ended the two week standoff that saw gas shutoffs to EU member states. The 10-year contracts took limited steps toward transparency by cutting out controversial gas intermediary RosUkrEnergo (co-owned by Gazprom and Ukrainian oligarch Dymtro Firtash) and establishing a fixed formula for determining the price of imported gas. The supply contract includes an annual 80 percent take or pay provision and allows for stiff penalties if Ukraine under or over purchases gas by 6 percent each month. The supply contract requires Ukraine to take 40 billion cubic meters (bcm) of gas in 2009 and 52 bcm per year from 2010. In 2009, Ukraine is receiving a 20 percent discount off of "market" prices. Ukraine is paying $270 per thousand cubic meters (tcm) of gas in the second quarter of
¶2009. Naftohaz and Gazprom estimated that the average purchase price for gas in 2009 would be around $230/tcm. In 2010, however, gas prices will reach market levels, which are derived from a formula pegged to oil prices. Ukraine is required to pay for each month's gas deliveries by the seventh of the following month. If Ukraine fails to make its monthly payment on time and in full, Gazprom can require it to make prepayment.

¶3. (SBU) Although the purchase price increased substantially, the transit price charged to Russia in 2009 remains below market levels at $1.70 per tcm per 100 kilometers. Transit prices will increase in 2010 to approximately $2.50 per tcm

per 100 kilometers. Depending on amounts shipped to the rest of Europe, Ukraine has historically received between $2.0 and $2.5 billion yearly from Gazprom for gas transit. While Ukraine is subject to take or pay provisions in the supply contract, Russia is not subject to similar provisions in the transit contract. Transit volumes to Europe were down 50 percent in the first quarter, as the financial crisis took its toll on European demand.

¶4. (SBU) Ukraine already faces several problems in fulfilling its contractual obligations. First, because of reduced demand from industrial consumers and increased reliance on gas Ukraine already had in storage, Ukraine has purchased far less than the commitments made in the gas agreements. Naftohaz officials asked for a revision to 33 bcm, which is allowed under the contract's 80 percent take or pay provision. Russian officials had warned that Ukraine could face stiff penalties -- $2 billion for the first four months of 2009 -- for taking less than the contracted amount. However, PM Tymoshenko allegedly secured Russia's agreement to waive the fines for 2009. Second, prior to the January 2009 supply contract, Ukraine paid for its gas as it was consumed, and not as it was delivered. This allowed Ukraine to pump gas into storage during the summer months, and pay for it later in the heating season when demand, and hence revenues, were high. The January 2009 contract, however, requires full payment for each month's gas deliveries by the seventh of the following month. During the winter season, this should not be a serious problem because Naftohaz generates revenues from the sale of gas. In the summer, however, it pumps up to 20 bcm into underground storage for use during the winter heaing season, and has far less

revenue, greatly limiting its ability to pay for this gas. In recent weeks, Russian and Gazprom officials repeatedly called into question Naftohaz's ability to make the May payment and warned of the possibility of another gas crisis. To date, however, Naftohaz has made the payments on time by borrowing over $650 million from state-owned banks and obtaining sufficient foreign exchange in a roundabout route from the National Bank of Ukraine.

Gas Sector Reform and Gas Transit System Modernization

¶5. (SBU) The March 23 EU-Ukraine investment conference devoted to the modernization of Ukraine's gas transit system (GTS) produced a pledge from Ukraine's leadership to undertake needed reforms. International financial institutions promised to provide financing for the modernization of the GTS once reforms were undertaken. The Brussels declaration calls on Ukraine to ensure the independence of the gas transit operator, and to undertake a gas sector reform program that would bring Ukraine in line with EU directives on the gas market. Ukraine is to provide a detailed timetable for sector reforms, which correspond with reforms needed for Ukraine to join the European Energy Community, by the end of 2009, and it is required to implement the reforms, which include the phasing out of domestic price subsidies, by 2011.

¶6. (SBU) Ukraine's gas sector is notoriously opaque and inefficient, with structured disincentives for investment and modernization, and is burdened with cross subsidies that mask the true cost and corruption of the system. Gas prices are largely based on political calculations. Industrial users pay the full cost of imported gas, while household consumers, organizations funded by the state budget, and municipal heating companies pay a heavily subsidized price, with the shortfall made up by allocations from the state budget. The small amount of domestically produced natural gas must be sold to domestic household consumers at a rate that barely covers the cost to extract and transit the gas. This cap on the sale price has discouraged production and exploration and led to a grey market that has furthered corruption.

Currently, domestic production is around 20 bcm per year, although many experts believe that Ukraine could double its production within a decade with the right changes to the investment and regulatory framework.

¶7. (SBU) The subsidized prices paid by domestic consumers leave Naftohaz heavily dependent on transfers from the state budget, and will make any attempts to increase the independence of Ukrtransgaz, the Naftohaz subsidiary that runs the GTS, more difficult. In their discussions with the Europeans, Ukrainian officials make the claim that Ukrtransgaz has already been unbundled. However, the company is fully subservient to Naftohaz. Transit revenues generated by Ukrtransgaz are used by Naftohaz to cross-subsidize gas purchases from Russia, and limit the amount of resources available to Ukrtransgaz to modernize the GTS. For example, Russia has reportedly already advanced all transit fees for 2009, which Naftohaz has used to cover gas payments.

¶8. (SBU) The European Commission, World Bank, European Bank for Reconstruction and Development, and the European Investment Bank have pledged to modernize the GTS with a $3.02 billion, seven year project that would increase capacity from 120 bcm to 150 bcm per year. The program would increase the reliability of the Ukrainian system and reduce its environmental impact by upgrading compressor stations, installing meters, and reconstructing two of Ukraine's underground gas storage facilities. Ukraine also proposed to add an additional 60 bcm of capacity by building new pipelines at a cost of $5.55 billion, an idea that has found little favor among the Europeans, who want Ukraine to focus on upgrading the existing system.

¶9. (SBU) The GTS modernization project has stalled since the March 23 Brussels conference. The EC was initially optimistic that Ukraine would quickly form a technical coordination unit with the western donors that would oversee the implementation of Naftohaz's modernization master plan. This unit, however, has not yet met. After Russia expressed its outrage at being excluded from the March 23 declaration, Ukraine made overtures to Russia. During meetings with Russian PM Putin that took place following the conference, PM Tymoshenko said that Russia would be involved in the project, although exactly how Russia would participate has not yet been outlined.

Ukraine's Oil Sector

¶10. (SBU) Ukraine imports 61 percent of its oil from Russia and 70 percent of its gasoline and diesel from Romania, Belarus, and Lithuania. Ukraine's six refineries operate far below capacity. Only one refinery, the Lysychansk refinery in eastern Ukraine owned by TNK-BP, has been modernized to reach European standards.

¶11. (SBU) When President Yushchenko talks about energy security, he invariably makes a pitch for the Odesa-Brody pipeline, Ukraine's most manifest, yet misguided, attempt to reduce dependence on Russian crude oil. The pipeline was completed in 2002 under President Kuchma. Both Kuchma and successive governments believed that business would surface once the pipeline was built, despite repeated advice by foreign experts that the project lacked a sound commercial underpinning. (Comment: Some observers argue that the project was primarily conceived as a cash cow for Interpipe, the pipe producer owned by Kuchma son-in-law Victor Pinchuk. End comment.) The pipeline remained empty until 2004 when TNK-BP and Transneft concluded a contract with the GOU to transport Urals crude in the opposite direction, from Brody south to Odesa. In 2007, TNK-BP shipped more than 9 Mt of Russian oil through the pipeline.

¶12. (SBU) President Yushchenko has revived efforts to

re-reverse Odesa-Brody with the hope of off-taking a percentage of oil to be refined at the Nadvirna and Drogobych refineries in western Ukraine. In order to achieve Yushchenko's goal, Ukraine would need to reconfigure an existing refinery to refine Caspian crude or invest in the construction of a new refinery, which could cost up to $4 billion. Yushchenko also aims to transport Caspian crude northward via the pipeline to Europe. Ukraine recently commissioned a feasibility study on shipping oil from Azerbaijan through the pipeline and lengthening the Odesa-Brody route to reach European markets. The total investment needed for the project is estimated to be anywhere between $2 billion and $8 billion, depending on the projected oil transit volumes. To date, however, Ukraine has still not succeeded in generating commercial interest for the idea.

¶13. (SBU) Ukraine could reduce its dependence on Russian oil by further developing onshore resources and by tapping the reserves of the Black Sea. However, as with the case with gas, developing the oil resources of the Black Sea will make little progress until Ukraine improves its investment climate. Most industry observers agree that Ukraine has neither the know-how nor the capital to develop its Black Sea resources on its own, yet the country has failed to attract investment from abroad. The most recent and visible example of Ukraine's inhospitable climate for foreign investors is the dispute with Houston-based Vanco. In October 2007 Vanco and the GOU, then headed by PM Victor Yanukovich, signed Ukraine's first Production Sharing Agreement (PSA), which targeted oil and gas exploration in the Prikercheskaya block in the Black Sea. However, PM Tymoshenko's government unilaterally revoked the PSA and Vanco's exploration permit in May 2008. Tymoshenko and other Ukrainian officials engaged in a heated public dispute with Vanco, charging the company with being the marionette of corrupt forces in both Ukraine and abroad. Oligarch Rinat Akhmetov, a bitter rival of Tymoshenko, is one of Vanco's partners in the project, and some observers in Kyiv claim that Tymoshenko is primarily set on derailing his participation in the project. Whatever the merits of Tymoshenko's arguments and Vanco's counterarguments, the case of a sovereign government unilaterally revoking a deal with a foreign investor will make it virtually impossible for Ukraine to obtain the type of long-term capital it needs to develop the Black Sea as long as the dispute is not settled. The case is now under consideration at the Stockholm Arbitration Court.

Nuclear Energy

¶14. (SBU) Ukraine's nuclear sector generates approximately half of the country's electricity, while Russia provides 100 percent of Ukraine's nuclear fuel and stores 60 percent of its spent fuel. Department of Energy (DoE) assistance totaling $380 million has helped Ukraine boost the operational capacity of its reactors by ten percent and significantly reduce reportable events. American firms

Westinghouse and Holtec have proposed projects that would diversify Ukraine's nuclear fuel supply and store spent fuel domestically. In March 2008, Westinghouse signed a contract with the GOU allowing it to supply nuclear fuel to three Ukrainian reactors beginning in 2011. Westinghouse has offered to extend the contract to cover additional reactors at a discount. Westinghouse has also offered to cooperate with Ukraine on technology transfer and construction of a nuclear fuel assembly plant. Although PM Tymoshenko and other senior GOU officials have publically supported the Westinghouse projects, the Prime Minister has also shown support for long term contracts with Russia to provide nuclear fuel to Ukraine. New Jersey-based Holtec, meanwhile, signed a contract in 2005 to build a $160 million central spent nuclear fuel facility in Ukraine. Currently, Ukraine spends approximately $100 million per year to ship its spent

fuel to Russia for reprocessing. The project has stalled, however, due to a lack of interest by PM Tymoshenko and hidden opposition from competing business interests and other senior GOU officials.

Municipal Heating Reform

¶15. (SBU) Nearly 30 percent of Ukraine's natural gas demand is used for municipal heating, a sector that is terribly inefficient and lacking in resources because of historically low prices. Municipal heating prices, set by local governments, reportedly cover 80 percent of costs, and nearly 60 percent of energy is wasted within the municipal heating chain. Half of this loss is attributable to waste and inefficiency by end users. In May USAID launched a three-year, $13.4 million program aimed at transforming municipal heating into a financially viable, well-managed, and fairly regulated sector that provides reliable services at affordable prices. The project will help 20 municipalities develop strategic energy plans and attract investment to the sector, while encouraging energy efficiency upgrades in apartment buildings to decrease overall energy needs. If Ukraine implements relevant reforms in the sector, it could potentially save $2 billion per year on energy costs.
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